

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER:SFL:FTL:TL-N-1822-99
JTLortie

date:

to: District Director, South Florida District
Roger Allen, Acting Associate Chief

from: District Counsel, South Florida District, Fort Lauderdale

subject: Claim of Right--I.R.C. Section 1341--

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On October 21, 1994, an advisory opinion was sent to the Ft. Lauderdale, District Director giving advice as to whether I.R.C. §1341 is applicable in this case where an individual receives compensation subject to an express contingency to repay at a later date. At that time, our office concluded that §1341 did not apply because the express contingency to repay, if it occurred, arose as the result of a subsequent event which did not exist at the time that the compensation was included in income. However, based on our further review and discussion with the National Office, we believe that §1341 should apply in this case.

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FACTS

The board of directors of [REDACTED] (" [REDACTED] ") agreed to pay [REDACTED]'s (" [REDACTED] ") legal expenses, in connection with his indictment for tax fraud, pertaining to his personal [REDACTED] through [REDACTED] tax returns. The payments to [REDACTED] were in the form of additional compensation. The parties agreed that if [REDACTED] were found guilty of criminal charges, he would have to repay [REDACTED] for all of the legal fees from [REDACTED] through trial and appeal of the criminal case. [REDACTED] was ultimately convicted. In [REDACTED], [REDACTED] reimbursed [REDACTED] the sum of \$ [REDACTED]. On his [REDACTED] return, [REDACTED] claimed \$ [REDACTED] as a deduction under I.R.C. §1341(a)(5).

ANALYSIS

I.R.C. §1341 states that if (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item; (2) a deduction is allowable for the taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and (3) the amount of such deduction exceeds \$3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following: (4) the tax for the taxable year computed with such deduction; or (5) an amount equal to-(A) the tax for the taxable year computed without such deduction, minus (B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

In order to satisfy the "unrestricted right" requirement in Section 1341, the taxpayer must prove that he reported an item of income in the prior year because it "appeared" that he had an "unrestricted right to such item," and that it was later established that the claim of right was defective. The taxpayer must show that, at the time of receipt, he did not, in fact, "have an unrestricted right to such item." Bailey v. Commissioner, 756 F.2d 44, 47 (6th Cir. 1985). If the taxpayer satisfies the "unrestricted right" requirement, he also must establish that, under some provision of the Internal Revenue Code, he is entitled to a deduction for the restoration payment in that year. See United States v. Skelly Oil Co., 394 U.S. 678, 683 (1969).

Under the claim of right doctrine, a taxpayer who receives income with no restriction on its disposition is obligated to include the amount in his gross income "even though it may still

be claimed that he is not entitled to retain the money, and even though he may still be declared liable to restore its equivalent." North American Oil Consolidated v. Burnet, 286 U.S. 417, 424 (1932).

In Dominion Resources, Inc. v. United States, 83 AFTR 2d ¶ 99-543 (E. D. Va. 1999), the district court recently held that a holding company for an electric company may apply §1341 to customer refunds. In that case, the company collected \$10 million in revenue from its customers during the years 1975 to 1987 when the corporate income tax rate was 46%. Due to a subsequent reduction in corporate tax rates for later tax years, an excess was created in the company's deferred tax account. In 1991, North Carolina and federal regulatory authorities ordered that the company refund to its customers the excess deferred tax revenues which totaled approximately \$10 million.

The company had included the customer payments from 1975 through 1987 in income and appeared to have an unrestricted right to that income. It was not until the subsequent event of the regulatory authorities and a change in the tax laws which required the company to refund the excess deferred revenues to its customers. The district court in Dominion Resources concluded that the taxpayer had met the requirements for relief under I.R.C. §1341(a)(1) & (2). Although we agree with the conclusion in Dominion Resources, we do not agree with the court's reliance upon the "substantive nexus" test rather than applying the "subsequent event" test established in prior cases such as Prince v. United States, 610 F. 2d 350 (5th Cir. 1980). Under the "substantive nexus" test, there must be a substantive nexus between the income event and the subsequent circumstances giving rise to the repayment of the funds previously included in income.

It is the Service's position that the proper test for applying section 1341 is the "subsequent events" test, not the "substantive nexus". The "subsequent events" test provides that §1341 does not apply in situations where the taxpayer had an unrestricted right to receive the money in a prior year and the obligation to repay the income arose as the result of subsequent events. Rev. Rul. 58-226, 1958-1 C.B. 50. In addition, the Service has taken the position that the taxpayer must show that in the year of inclusion the taxpayer did not have in fact or in law an unrestricted right to the amount in question. Rev. Rul. 68-153, 1968-1 C.B. 371.

A number of court cases have supported the Service's position and applied the "subsequent events" test in determining whether to grant the taxpayer relief under section 1341. For example, the Sixth Circuit Court of Appeals and the Tax Court have held that section 1341 applies where the lack of an unrestricted right to an income item permitting deduction arises out of the circumstances, terms and conditions of the original payment of such item to the taxpayer and not out of circumstances, terms, and conditions imposed upon the payment by reason of some subsequent agreement (i.e. subsequent event) between the payor and payee. Bailey v. Commissioner, 756 F.2d 44, 47 (6th Cir. 1985); Blanton v. Commissioner, 46 T.C. 527 (1966), aff'd, 379 F.2d 558 (5th Cir. 1967); Pahl v. Commissioner, 67 T.C. 286 (1976). The law is well established that if the taxpayer had an absolute right to the income in the prior year and the amounts were restored due to a subsequent event independent of the terms and conditions under which he originally received the income, then the taxpayer would not be entitled to relief under section 1341. Bailey v. Commissioner, supra; Prince v. United States, supra.

Applying the "subsequent events" test to the facts here, we conclude that [REDACTED] received the payment for his legal fees with the appearance of an unrestricted right. [REDACTED] reported the additional income received from [REDACTED] on his income tax returns because it "appeared" that he had an unrestricted right to the income. The unrestricted right occurred because [REDACTED] would not have to repay [REDACTED] if he was cleared of the fraud charges. Also, the condition on his right to retain the money (i.e. that he be found not guilty) remained in existence during [REDACTED] through [REDACTED] which were the years in which he included the payment of his legal fees in income.

At the time the money was paid to [REDACTED] he had not been convicted of fraud. However, it was later discovered that [REDACTED] didn't have an unrestricted right to the additional income because he had to repay the money after he was convicted of tax fraud. This was a subsequent event which arose out of the "circumstances, terms, and conditions" of the original payment of the attorney's fees. Therefore, [REDACTED] should be allowed a deduction under section 1341 for the repayment of those fees in the subsequent year.

If you have any other questions, please contact attorney John Lortie at (954)423-7944. Written correspondence should be sent to Mr. John Lortie's attention, District Counsel, Atrium West, Suite 240, 7771 West Oakland Park Boulevard, Sunrise, Florida 33351.

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NOTED:

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